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Faculty Working Papers

**NEGOTIATED COMMISSIONS AND THE THIRD
MARKET**

Frank K. Reilly

#429

**College of Commerce and Business Administration
University of Illinois at Urbana-Champaign**

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Abstract

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The fixed commission structure on the NYSE has changed dramatically during the 1970's culminating in completely negotiated commissions in May, 1975. Because the third market prospered with fixed commissions it is important to determine what has happened to this market since the commission structure changed. The results reported here indicate the prophets of doom have been correct so far, but there are signs of stability.

NEGOTIATED COMMISSIONS AND THE THIRD MARKET*

Frank K. Reilly**

INTRODUCTION

From the day of its founding in 1792 until the 1960's, the New York Stock Exchange (NYSE) had an established policy of minimum commissions which its members could charge customers for the execution of orders of all sizes on the Exchange. In December, 1968 the schedule was slightly modified to allow quantity discounts to very large orders. In the 1970's, at the behest of the SEC, the principle of minimum commissions was gradually eliminated. Specifically, in April, 1971 the commissions on all orders over \$500,000 became negotiated. Subsequently, in April, 1972 the commission on all orders over \$300,000 became negotiated. Finally, on May 1, 1975 ("May Day"), the minimum rate structure was abolished entirely--commissions on all trades became fully negotiated.

Prior to May Day there were extensive discussions of the potential effect this change in commission structure would have on various segments of the securities industry. A major concern was the effect of this change on the "Third Market." The third market is the trading of listed securities on the over-the-counter market by non-member brokerage firms. Observers were concerned for the third market because this segment of the industry had experienced rapid growth and prosperity during the latter half of the 1960's and the early 1970's at the expense of the NYSE simply because of the minimum commission schedule. Specifically, the third market grew because there

*The author acknowledges the comments by Donald Weeden, the assistance of Young Kim, Ron Peterson, and especially Paul Skelton, and the use of the computer facilities at the University of Illinois.

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was an increase in the trading by institutions and the commission charge for large trades on the third market was substantially lower than the cost on the NYSE with its minimum commission schedule that did not adequately allow for the economies of scale in trading. These large trades included "blocks" (10,000 shares or more), but also included many orders by institutions of under 10,000 shares. In addition, the market-making by dealers on the third market improved substantially over time in terms of the depth and liquidity of the markets for stocks with active institutional following. Finally, the third market benefitted because third market trades were not reported on the tape. This lack of publicity was considered desirable by some institutions buying or selling a block--especially if they were contemplating a subsequent transaction. In summary, the third market experienced substantial growth since 1965 for three reasons, the greatest of which was the lower commission costs. The question of concern then was, what would be the effect of fully negotiated rates on the third market since the market would lose its greatest advantage? In addition, the third market lost its secrecy advantage in June, 1975. At that time the consolidated tape that reported trades for all stocks on the NYSE was implemented and includes third market trades. Therefore, many observers have hypothesized that third market volume would decline as a percent of NYSE volume.¹

In contrast to the prophets of doom, conversations with institutional portfolio managers following the change indicated that the outlook may not be as bad as initially expected. It was contended that commission charges on the third market were "competitive" with the negotiated rates on the exchanges and the market-making by third market dealers was quite good in

¹An article that briefly discusses this point as applied to a major third market dealer is, Pamela Archbold, "What Weeden Is Doing to Survive," Institutional Investor, Vol. 8, No. 11 (November, 1974), p. 51.

[illegible]

4-21 with the following comments: "Satisfactory" and "Good".

the evidence of such a connection is not sufficient to establish a causal link between the two.

10. The Commission has also received information from the United States that the United States has been providing information to the United States regarding the activities of the United States in the United States.

1. The first group of people who are affected by the disease are those who are in the early stages of the disease. They are usually young people who are in the early stages of the disease. They are usually young people who are in the early stages of the disease.

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For the APX to function, H.S. must exist.

11. Under the provisions of the proposed bill, the Secretary of the Interior is authorized to

the following information was obtained:

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1. *Chlorophyll a* and *Chlorophyll b* were determined by the method of Lichtenthaler and Whistler (1973). The total chlorophyll content was determined by the method of Arar and Cook (1980).

The following are the names of the persons who have been
 appointed to the various positions in the various
 departments of the Government of the State of New York.
 The names are given in alphabetical order of the
 departments.

terms of liquidity and depth. One might also be encouraged by a study of the effect of the change in NYSE fee structure in December, 1968.² Specifically, in December, 1968 the NYSE revised its fee structure to permit discounts for large block trades. The analysis by Fredman and Johnson indicated no adverse effects on the percent of trading on the third market. In fact, the percent of trading on the third market was substantially higher a year after the change.

Given the importance of the third market to the total capital market complex and the differing opinion regarding the effects of negotiated commissions, this study examines the recent history of the third market since data became available in 1965 to the present. The emphasis is on the periods surrounding the changes in commission rates since 1971: April, 1971; April, 1972; and May, 1975.

THIRD MARKET COMPARED TO TOTAL NYSE VOLUME

Table 1 contains figures that indicate the ratio of third market volume in NYSE listed stocks to total NYSE volume (share volume and dollar value of trading), from the beginning of 1965 through the fourth quarter of 1976. These data are reported quarterly in the SEC Statistical Bulletin. A time series plot of the two series is contained in Figure 1.

Notably, the percent of trading in dollar terms is always larger than the share percent. This is because the bulk of trading on the third market is in stocks with institutional interest and the prices on these institutional stocks are above the average price of all stocks on the NYSE.

²Albert J. Fredman and Clarke C. Johnson, "Effect of New NYSE Fee Structure on the Third Market," Financial Executive, Vol. 38, No. 10 (October, 1970), pp. 18-23.

forms a relatively small part of the total. The main part of the total is made up of the following: (1) the cost of the land, (2) the cost of the buildings, (3) the cost of the equipment, (4) the cost of the inventory, (5) the cost of the working capital, (6) the cost of the overheads, (7) the cost of the interest, (8) the cost of the depreciation, (9) the cost of the taxes, (10) the cost of the insurance, (11) the cost of the other expenses. The total cost of the business is the sum of these ten items. The cost of the land is the most important item, and it is the only one which is not affected by the business. The cost of the buildings is the next most important item, and it is also the only one which is not affected by the business. The cost of the equipment is the third most important item, and it is also the only one which is not affected by the business. The cost of the inventory is the fourth most important item, and it is also the only one which is not affected by the business. The cost of the working capital is the fifth most important item, and it is also the only one which is not affected by the business. The cost of the overheads is the sixth most important item, and it is also the only one which is not affected by the business. The cost of the interest is the seventh most important item, and it is also the only one which is not affected by the business. The cost of the depreciation is the eighth most important item, and it is also the only one which is not affected by the business. The cost of the taxes is the ninth most important item, and it is also the only one which is not affected by the business. The cost of the insurance is the tenth most important item, and it is also the only one which is not affected by the business.

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THE COST OF THE BUSINESS

The cost of the business is the sum of the cost of the land, the cost of the buildings, the cost of the equipment, the cost of the inventory, the cost of the working capital, the cost of the overheads, the cost of the interest, the cost of the depreciation, the cost of the taxes, and the cost of the insurance. The cost of the land is the most important item, and it is the only one which is not affected by the business. The cost of the buildings is the next most important item, and it is also the only one which is not affected by the business. The cost of the equipment is the third most important item, and it is also the only one which is not affected by the business. The cost of the inventory is the fourth most important item, and it is also the only one which is not affected by the business. The cost of the working capital is the fifth most important item, and it is also the only one which is not affected by the business. The cost of the overheads is the sixth most important item, and it is also the only one which is not affected by the business. The cost of the interest is the seventh most important item, and it is also the only one which is not affected by the business. The cost of the depreciation is the eighth most important item, and it is also the only one which is not affected by the business. The cost of the taxes is the ninth most important item, and it is also the only one which is not affected by the business. The cost of the insurance is the tenth most important item, and it is also the only one which is not affected by the business.

The three quarters of interest (2/71;2/72;2/75) are starred in the table and there are arrows on the chart. The first change to negotiated rates came during the second quarter of 1971 and apparently had little or no effect. Specifically, the percent of trading on the third market continued to increase steadily during the subsequent two quarters. There was a small decline during the third quarter followed by an increase. Clearly, the percent of trading on the third market a year after the commission change was substantially higher than during the quarter of the change (i.e., 7.8 percent versus 6.8 percent in shares and 9 percent versus 7.9 percent in dollar value of trading). These results are consistent with those reported by Fredman and Johnson.

The second change came during the second quarter of 1972 and apparently had little or no initial effect. During the quarter of the change the percent of trading on the third market increased and the percent rose again during the following quarter. The figures indicate a delayed effect because the percent of trading dropped drastically during the fourth quarter of 1972. There was a small recovery (in share percent) during the first quarter of 1973, followed by steady declines during the subsequent two quarters. Overall, it appears the second change in the commission structure had a delayed effect, but the effect was clearly detrimental to the relative trading activity on the third market.

The third and final change in the commission structure came during the second quarter of 1975. During the quarter of the change both the share and dollar ratios increased slightly. For the subsequent three quarters the ratios declined steadily followed by a small recovery during 2/76 and then further declines. By the fourth quarter of 1976 the share ratio was below

the other hand, the interest rate was 10% in 1970 and 15% in 1971.

and there was a strong tendency to increase the interest rate.

Some during the period 1970-1971 and especially in 1971.

It is also possible that the interest rate was not as high as it should be.

to increase the interest rate, but the government did not do so.

despite the fact that the interest rate was 10% in 1970 and 15% in 1971.

It is also possible that the interest rate was not as high as it should be.

substantially higher than during the period 1970-1971.

It is also possible that the interest rate was not as high as it should be.

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1970-1971

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4 percent and the dollar ratio was below 5 percent. Therefore, it appears that the final change in the commission structure continued to have an adverse effect on the third market as shown by its relative volume that declined to its lowest point since the fourth quarter of 1968.

In summary, the analysis of trends in third market volume as a percent of NYSE volume indicates that the initial change to negotiated rates on trades above \$500,000 had no effect on the third market. In contrast, the second change to negotiated commissions on trades over \$300,000 had a delayed effect, but the ultimate effect appeared to be adverse to the third market and the impact was substantial. Finally, this adverse impact continued after the change to fully negotiated commissions.

THIRD MARKET COMPARED TO INSTITUTIONAL TRADING

As noted earlier, the bulk of trading on the third market is by institutions. Therefore, in addition to an analysis of third market trading compared to total NYSE volume, it seems appropriate to consider third market trading relative to the trading by its major customers--i.e., the institutions. This analysis is in two parts. The first part compares third market volume to block trading volume while the second part compares the dollar value of trading on the third market to the dollar volume of purchases and sales by institutions.

Third Market Relative to Block Trading

Table 2 contains the ratio of third market share volume to block share volume on the NYSE. The subsequent column reports third market dollar volume to the dollar volume of block trading on the NYSE. The trend in the ratio is of interest because most third market trading is by institutions and likewise almost all block trading on the NYSE is by institutions.

1. The first step in the process of the investigation is to identify the problem.

2. The second step is to collect data and information related to the problem.

3. The third step is to analyze the data and information to identify the cause of the problem.

4. The fourth step is to develop a plan of action to address the problem.

5. The fifth step is to implement the plan of action and monitor the results.

6. The sixth step is to evaluate the results and determine if the problem has been solved.

7. The seventh step is to document the findings and conclusions of the investigation.

8. The eighth step is to communicate the findings and conclusions to the appropriate parties.

9. The ninth step is to take corrective action to prevent the problem from recurring.

10. The tenth step is to review the process and make any necessary improvements.

11. The eleventh step is to ensure that the problem is fully resolved.

2. The second step is to collect data and information related to the problem.

12. The twelfth step is to identify the sources of data and information.

13. The thirteenth step is to determine the methods for collecting data and information.

14. The fourteenth step is to collect the data and information.

15. The fifteenth step is to organize the data and information.

16. The sixteenth step is to analyze the data and information.

17. The seventeenth step is to identify the cause of the problem.

18. The eighteenth step is to develop a plan of action to address the problem.

19. The nineteenth step is to implement the plan of action.

3. The third step is to analyze the data and information to identify the cause of the problem.

20. The twentieth step is to identify the factors that contribute to the problem.

21. The twenty-first step is to determine the relationships between the factors.

22. The twenty-second step is to identify the root cause of the problem.

23. The twenty-third step is to develop a plan of action to address the problem.

24. The twenty-fourth step is to implement the plan of action.

Again, the dollar ratios are consistently higher than the share ratios which indicates that third market trading is generally in higher priced shares than the average price of shares included in block trades on the NYSE. Notably, the spread has been narrowing over time although the series are always parallel.

The figures in Table 2 and the time series plot of the two series contained in Figure 2 indicate a dramatic decline in the ratio during the period 1965 to the beginning of 1969. An analysis of the individual series indicates that this decline was not due to a lack of growth in third market volume, but was caused by a dramatic growth in block trading. Specifically, during the period 1965 to 1969, third market trading increased about 350 percent, but block trading increased over 1,000 percent.

An examination of the period following the first change in 1971 indicates no adverse effects for the third market--both ratios are higher during the second quarter of 1972 than the second quarter of 1971. Following the second change in 1972 there was a definite effect as the ratios declined steadily for the next three quarters followed by an increase and then another decline. There were two increases (in 4/73 and 1/74) again followed by a series of steady declines through the first quarter of 1975. Interestingly, there was a small increase during the second quarter of 1975 when the final change came. Following the final change to fully competitive rates the ratios declined and finished the year 1976 at the lowest ratio recorded during the total period except for the ratio during the third quarter of 1976.

In summary, an analysis of third market volume (share and dollar volume) relative to block trading volume on the NYSE generated results that were consistent with the prior analysis of third market volume relative to total trading volume on the NYSE. There was a very sharp decline in the ratio

during the initial periods in 1965 and 1966 because of the very rapid growth in block trading. An examination of the specific periods surrounding the three major changes in the commission structure indicated no adverse effect following the first change in April, 1971. In fact, the ratios were higher a year later. In contrast, there were clearly adverse effects following the last two changes. Except for three quarters when there were some increases, the ratios declined steadily to end 1976 at the lowest points on the chart. These results were consistent with the results when third market volume was compared to overall NYSE volume.

Third Market Relative to Institutional Purchases and Sales

The SEC has a quarterly series of common stock transactions by selected financial institutions including private noninsured pension funds, open-end investment companies, life insurance companies, and property-liability insurance companies. An analysis of third market dollar volume compared to transactions for this group of institutions should provide another indication of the effect of the change in the commission structure on third market volume as it relates to a major customer of the third market. The figures are contained in Table 2 and a time series plot of the ratio is in Figure 3.

Again, some of the ratios during the early period are heavily influenced by the relative growth rates for the individual series. This caused a major decline in the ratio during 1965 and 1966, and the ratio remained below 9 percent until mid-1969. Subsequently there was a strong increase from the latter part of 1969 to the first quarter of 1971. During the quarter of the initial change in commission structure the ratio declined dramatically. Subsequently the ratio increased and during all of the following four quarters it was much higher than during the quarter of the change.

1. The first of these is the fact that the
2. black population in the United States is
3. growing at a rapid rate. In 1960, the
4. black population was 10.8 million, or 13.3
5. percent of the total population. By 1980,
6. it is projected to be 20.8 million, or
7. 18.3 percent of the total population. This
8. increase is due to a number of factors,
9. including a high birth rate, immigration
10. from other countries, and a decrease in
11. the death rate. The increase in the black
12. population has led to a number of social
13. and economic problems, including poverty,
14. unemployment, and discrimination. These
15. problems have led to a number of social
16. and economic reforms, including the Civil
17. Rights Act of 1964 and the Voting Rights
18. Act of 1965. These reforms have led to
19. a number of improvements in the lives of
20. black Americans, but there is still a
21. long way to go. The black population
22. continues to grow, and the problems
23. associated with it continue to exist.
24. It is therefore essential that we
25. continue to work for social and economic
26. reforms that will improve the lives of
27. all Americans, regardless of race.

The second change during the second quarter of 1972 was followed by a small increase during the third quarter. Subsequently the ratio declined drastically and was below the second quarter, 1972 ratio during the next five quarters.

At the time of the final change (2/75), the ratio was somewhat below the ratio in 1972. The ratio generally declined except for a sharp recovery during 1/76 and ended 1976 at a ratio that prevailed in 1970.

Therefore, after one takes account of the increase of the ratio prior to any of the commission changes, the results are generally similar to the results from the prior two comparisons. Again, the first change appeared to have no effect. In contrast there was a definite decline in the ratio after the second change that generally continued for five quarters. Finally, since "May Day" the ratio has almost always been below the ratio that prevailed during the quarter of the change.

SUMMARY AND CONCLUSION

Summary

The absolute and relative amount of trading on the third market grew steadily from 1965 into 1972. This growth was attributable to lower commissions than on the NYSE because of the fixed commission schedule, secrecy of reporting trades, and good market-making. Notably, the commission advantage declined since 1971 and disappeared in 1975. Also with the introduction of the consolidated tape the secrecy advantage was lost. Therefore some observers have contended that the third market would decline in relative importance.

Three comparisons were made of relative third market volume since 1965 with an emphasis on the periods surrounding the three changes in 1971, 1972, and 1975. The analysis of third market volume relative to NYSE volume indicated that the first change in the commission structure in 1971 had no effect on the relative position of the third market. In fact, the relative volume on the third market increased during the subsequent year. After the second change the effect appeared to be somewhat delayed, but within a couple of quarters the relative volume turned down and continued to decline. Following "May Day" relative volume on the third market continued to decline and ended 1976 at a level about half of its peak ratio in 1972.

Two other comparisons examined third market volume relative to block trades on the NYSE, and relative to total purchases and sales by financial institutions because these two series are indicative of trading by the main customers of the third market. In both cases there were some unusual trends in the ratios during the period 1965-1970 due to differential growth. At the same time, the analysis of both sets of ratios for the periods surrounding the three changes were all the same. Specifically, in all cases there was no adverse affect after the first change, but all ratios of third market volume clearly declined after the last two changes.

Conclusion

It appears that the prophets of doom regarding the third market have been essentially correct thusfar regarding the effect of the commission changes on the third market. The remaining question is whether the decline has possibly ended and a certain amount of stability may return although at a lower rate of relative activity than prevailed during the period prior to the second change in commissions. Specifically, it has been suggested that the initial decline on the third market was because

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institutions had fewer commission dollars due to the negotiated environment and it was necessary to use these dollars to pay for the research and support provided by firms that were members of the NYSE. Therefore, more business than usual went to the Exchange. It is speculated that eventually the institutions will pay off their commitments to these firms and become more conscious of execution. Put another way, prior to "May Day" the institutions had heavy commitments to a large number of research firms that were paid through NYSE commissions. It is contended that it was a long process to pay off these commitments and reduce the list of firms receiving commission business in return for research. Obviously, only further observations will indicate whether the trough has been reached in this respect. Unfortunately, the reporting of third market data is quite slow--the figures for the fourth quarter of 1976 were not released until the July, 1977 Statistical Bulletin.

TABLE 1

THIRD MARKET SALES AS A PERCENT
OF NEW YORK STOCK EXCHANGE SALES

	No. of SHARES	DOLLAR VALUE		No. of SHARES	DOLLAR VALUE
1st Q 1965	3.1	4.1	1st Q 1973	6.4	7.3
2nd Q	2.8	3.5	2nd Q	5.9	7.2
3rd Q	2.7	3.4	3rd Q	5.3	6.6
4th Q	2.3	2.9	4th Q	5.4	6.6
1st Q 1966	2.5	2.9	1st Q 1974	5.8	7.5
2nd Q	2.4	2.8	2nd Q	5.8	7.8
3rd Q	2.8	2.9	3rd Q	5.0	6.3
4th Q	2.9	3.2	4th Q	4.8	6.3
1st Q 1967	2.7	3.1	1st Q 1975	4.7	5.9
2nd Q	3.0	3.3	*2nd Q	4.9	6.7
3rd Q	3.0	3.5	3rd Q	4.4	5.7
4th Q	3.1	3.4	4th Q	4.4	5.7
1st Q 1968	3.5	3.9	1st Q 1976	3.8	4.4
2nd Q	3.2	3.6	2nd Q	4.1	5.4
3rd Q	3.6	4.4	3rd Q	3.6	4.1
4th Q	4.2	4.7	4th Q	3.7	4.7
1st Q 1969	4.0	4.7			
2nd Q	4.5	5.1			
3rd Q	5.4	5.8			
4th Q	5.7	6.4			
1st Q 1970	6.4	7.2			
2nd Q	5.9	6.9			
3rd Q	6.7	8.5			
4th Q	7.0	8.6			
1st Q 1971	6.3	8.3			
*2nd Q	6.8	7.9			
3rd Q	7.2	8.3			
4th Q	7.8	9.3			
1st Q 1972	7.2	8.6			
*2nd Q	7.8	9.0			
3rd Q	8.3	9.1			
4th Q	6.1	7.4			

*Indicates quarters when changes were made in commission structure.

Source: SEC Statistical Bulletin

T A B L E 2

THIRD MARKET VOLUME AS A PERCENT OF BLOCK
TRADING VOLUME ON THE NYSE AND PURCHASES
AND SALES BY SELECTED FINANCIAL INSTITUTIONS

Qtr./Yr.	3rd Mkt. Shs. Blk. Shs. (%)	3rd Blk. \$ (%)	3rd Mkt. \$ Inst. P & S (%)	Qtr./Yr.	3rd Mkt. Shs. Blk. Shs. (%)	3rd Mkt. \$ Blk. \$ (%)	3rd Mkt. \$ Inst. P & S (%)
1/65	103.6	142.5	12.3	1/71	42.0	53.6	13.7
2/65	95.3	121.0	10.8	2/71	41.0	46.2	12.3
3/65	95.9	129.6	10.7	3/71	41.4	47.3	12.9
4/65	104.8	145.0	10.2	4/71	43.6	53.9	15.0
1/66	79.0	110.4	9.7	1/72	43.8	53.0	14.5
2/66	68.9	92.9	8.6	2/72	46.8	55.0	13.3
3/66	65.2	75.3	8.1	3/72	45.2	53.6	14.0
4/66	61.5	73.7	8.6	4/72	35.4	45.4	12.2
1/67	51.7	69.9	8.9	1/73	33.0	43.9	11.3
2/67	52.9	64.6	8.9	2/73	35.2	54.3	13.7
3/67	51.1	64.5	8.7	3/73	30.2	42.4	11.3
4/67	43.3	50.5	8.4	4/73	39.0	55.6	12.3
1/68	51.4	60.3	9.9	1/74	42.7	64.0	14.6
2/68	39.9	45.6	8.5	2/74	38.3	53.5	13.3
3/68	40.0	46.9	8.7	3/74	34.0	52.5	12.8
4/68	37.0	39.7	9.0	4/74	28.2	33.2	12.9
1/69	53.4	39.0	8.3	1/75	32.3	46.7	11.6
2/69	34.7	42.7	8.1	2/75	23.2	41.0	13.4
3/69	40.0	47.2	9.0	3/75	23.2	36.2	11.7
4/69	45.9	54.2	10.4	4/75	23.4	43.0	10.9
1/70	45.7	56.8	10.7	1/76	23.1	22.2	15.3
2/70	50.0	66.5	11.7	2/76	15.5	23.8	11.8
3/70	42.5	57.3	12.1	3/76	19.7	24.5	10.5
4/70	48.9	60.9	12.6	4/76			11.0

Source: SEC Statistical Bulletin; New York Stock Exchange Fact Book.

FIGURE 1

TIME SERIES PLOT OF THIRD MARKET VOLUME
AS A PERCENT OF NYSE VOLUME
QUARTERLY: 1965-1976

PER
CENT

10

9

8

7

6

5

4

3

2

1

0

\$ VALUE

NO OF
SHARES

1965

1966

1967

1968

1968

1970

1971

1972

1973

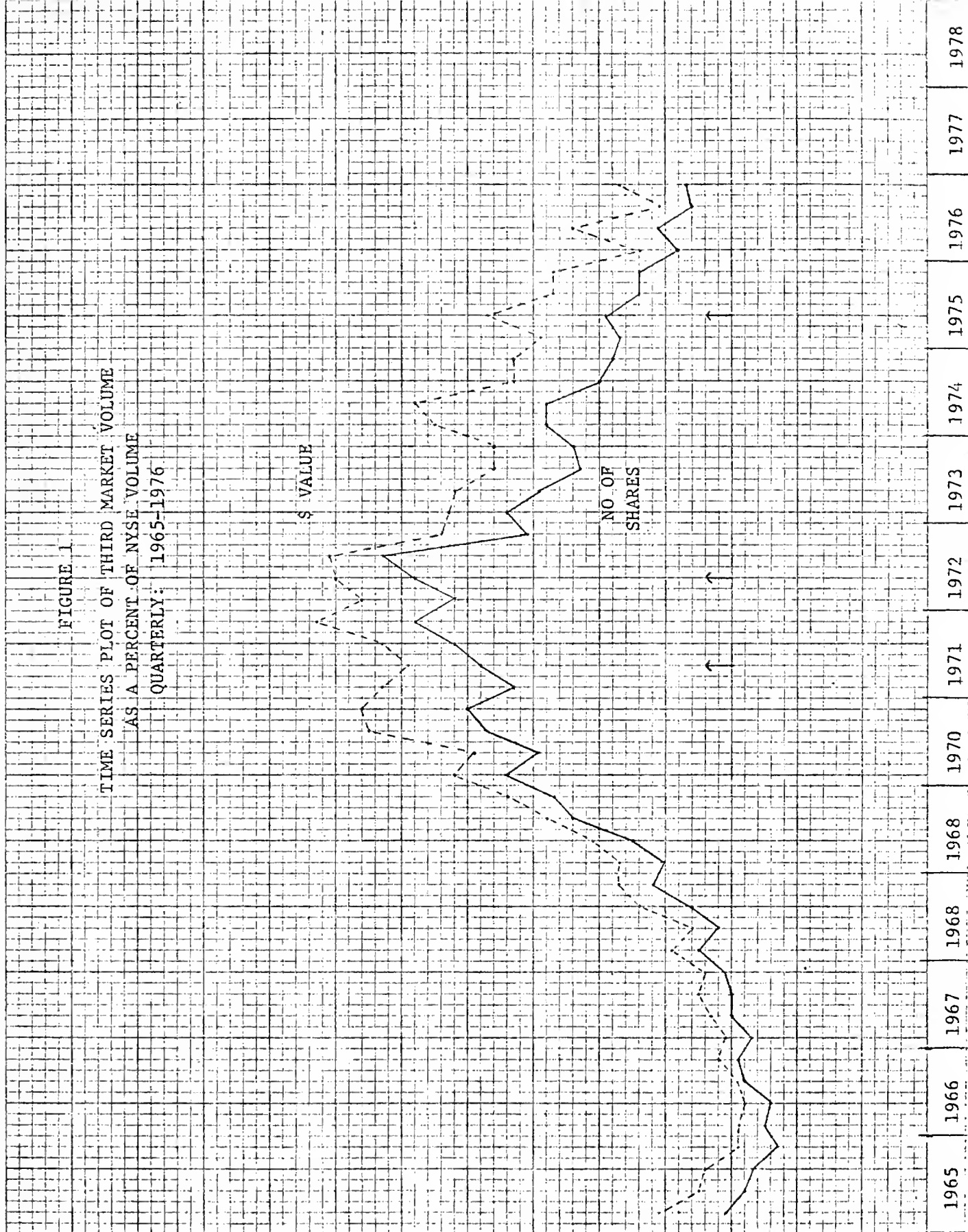
1974

1975

1976

1977

1978



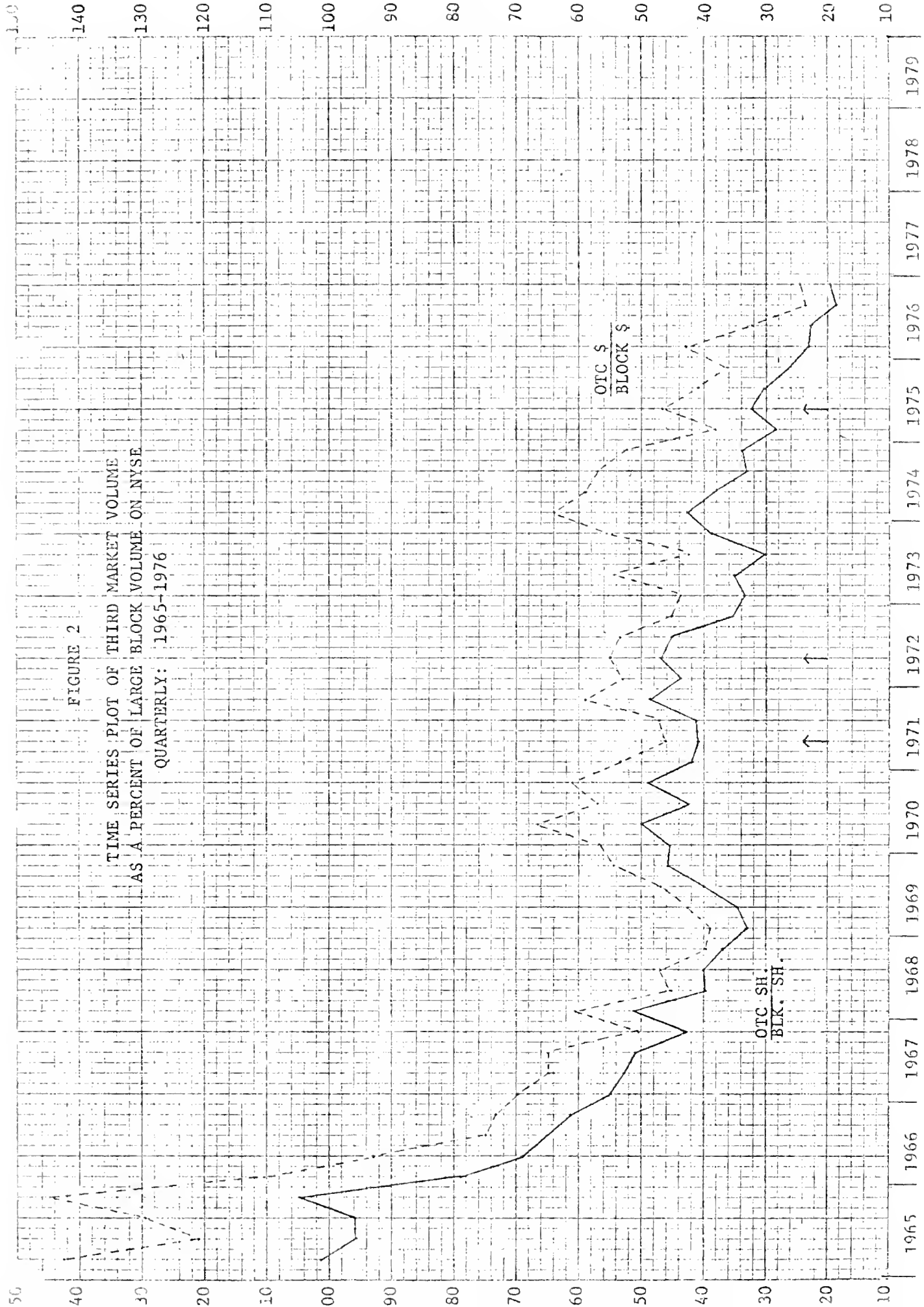
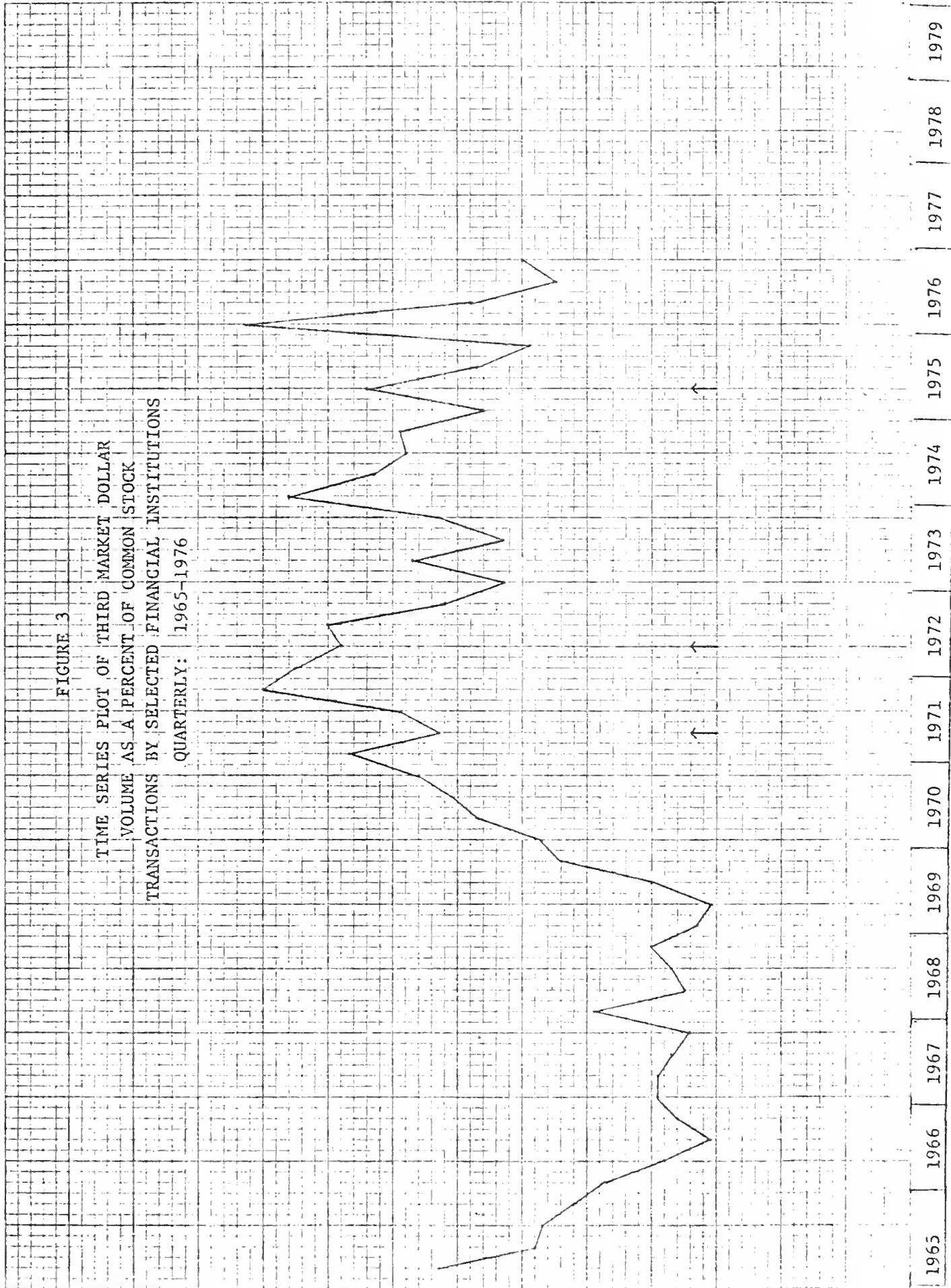


FIGURE 3

TIME SERIES PLOT OF THIRD MARKET DOLLAR
VOLUME AS A PERCENT OF COMMON STOCK
TRANSACTIONS BY SELECTED FINANCIAL INSTITUTIONS
QUARTERLY: 1965-1976





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